RECORD, Volume 22, No. 1*

Marco Island Spring Meeting
May 29–31, 1996

Session 87D
Life Insurance Sales Illustrations—What's Next?

Track: Product Development
Key words: Illustrations, Product Development, Sales, Standards

Moderator: TIMOTHY F. HARRIS
Panelists: DEANNE L. OSGOOD
THOMAS A. PHILLIPS
JAMES N. VAN ELSEN
Recorder: TIMOTHY F. HARRIS

Summary: The participants are key players in the ongoing development of the NAIC model for illustration, regulation, and the Actuarial Standards of Practice (ASOP) on illustrations. Topics include:

- *Does the law go far enough?*
- *How liable is the illustration actuary?*
- *Generally Recognized Expense Table (GRET).*

Mr. Timothy F. Harris: Although this session was listed in the program booklet as a debate, there's no longer any reason to debate the issue; the Life Insurance Illustration Regulation and the ASOP on illustrations are here. We're going to have to learn how to live and comply with both of them and that's going to be our focus. We're going to focus on how actuaries should be complying with the regulation and the ASOP. We're going to give some brief prepared presentations, and then we'll open things up for discussion. I'd like as much participation as possible from the audience. I've found, in my involvement in the life insurance illustration area, that many people have questions but many times we don't have, and no one else seems to have the answers to these questions. There are many fine points that really haven't been thought through yet.

My background in this area is that I was on the Life Committee of the Actuarial Standards Board (ASB) when the committee was first looking at the possibility of the NAIC coming out with a regulation and the Actuarial Standards Board backing that up with an ASOP. I'm also a member of the Life Research Committee and chairperson of a subgroup of that committee that has been putting together this generally recognized expense table. I'm also part of the group that's trying to prepare practice notes to help actuaries deal with some of the questions that are coming up. We have received several hundred questions at this point. I suspect there are even more out there floating around. I'm also a consultant for Milliman & Robertson in the St. Louis office.

We have three panelists who have had some experience in this area as things have led up to the regulation and the ASOP and are also trying to cope with life under these new requirements. The first presenter is going to be Tom Phillips. Tom is responsible for product pricing and product development at the Principal Financial Group in Des Moines. He's also a member of the Practice Notes Committee on the illustration issue and he is involved in the ACLI Committee with respect to variable life Illustrations.

Mr. Thomas A. Phillips: As Tim said, he and I have been working together as part of the group that is developing the practice notes. One thing that struck me with respect to that process is that this is the first set of Life Insurance Practice Notes that I've seen that attempts to define sound actuarial practice, rather than codify sound actuarial practice, which already exists, and I expect that you will all get the feel of that from our remarks. We'll be attempting to give you some reasonable thoughts and solutions to our regulation problems. However, none of us can really give definitive answers to the ambiguities that you see in the regulation and the ASOP.

I'm going to begin the presentations with a discussion of the illustration regulation from the large-company perspective. That's going to give a certain flavor to my presentation. First, you're going to get the viewpoint of the illustration actuary. I am not the company responsible officer, and I won't deal with issues of actual illustrations. I'll confine my comments to the actuarial issues with respect to the regulation and the ASOP.

Second, being a large company, we feel sales are illustration driven, and we need to comply with all of our products. We don't even consider the possibility of not illustrating a particular policy form. Third, we will comply with the regulation. We're in all 50 states and the regulation will be in effect in some states by the end of the year. We're preparing for full compliance, and one of our goals is to have uniformity in the application of the regulation. Finally, I will be taking the perspective of a dividend scale in my remarks, but they should be equally applicable to nonguaranteed elements of life products. By way of introduction, I'm going to walk through some considerations for developing a disciplined current scale and doing the self-support and lapse-support tests defined in the regulation.

The first question that I'll pose will deal very basically with the concept of a disciplined current scale, and that simply stated is: What approach does the illustration actuary take when developing a disciplined current scale? Through the work we've done, we've come up with two distinct points of view. One possibility is simply to qualify your currently payable scale as a disciplined current scale. Now, this eminently practical approach says, look at your recent historical experience and develop a set of reasonable assumptions. Run the self-support and lapse-support tests using your current dividend scale and the assumptions you've developed. If your products pass, the dividend scale qualifies as a disciplined current scale and can be so certified.

The second possibility is to look at recent historical experience and develop assumptions for a disciplined current scale that represents the maximum that can be paid in dividends for a given product. If these assumptions for the disciplined current scale are set consistently with the currently payable scale, this gives flexibility to vary the currently payable scale without having to recompute any test results. The current scale factors can be varied in any way, so long as the resulting dividends are less than those produced by the disciplined current scale. From a large-company perspective, I see some advantage in this second approach.

It allows the flexibility of retaining a disciplined current scale over a period of time, perhaps several years when factors don't vary much, and it would allow some easy ongoing changes in the factors and the dividend scale. As long as the factors for the illustrated scale are kept below the maximum set by the discipline current scale, the illustrated scale can be used.

Let's turn to some of the assumptions underlying the disciplined current scale. We'll begin with expenses. As I set the stage in talking about factors, bear in mind that assumptions based on recent historical experience are not necessarily pricing factors. There are several reasons why recent historical experience could be higher or lower than pricing factors. Pricing assumptions can be set more conservatively than recent historical experience might justify, or pricing assumptions may socialize costs over different generations or classes of policyholders in one way or another.

For expenses, you obviously have the choice of using your own fully allocated expenses, marginal expenses, or the generally recognized expense table. I'll begin by apologizing to Tim, who has performed a great deal of work on the GRET, that those tables will probably not be used, to a large extent, by the larger companies, as much as they'll be used by the smaller companies. The annual expense analysis that we do produces expense allocations that are quite a bit different than the GRET.

So how might fully allocated expenses be developed, or how are you to decide if a given set of expense factors represent fully allocated expenses? I'll run through an example of a method that seems reasonable to use.

First, in looking at expenses, it would appear necessary to start with some overall total company expense number, such as total statutory expenses or total GAAP expenses. Next are the adjustments for nonrecurring expenses, as allowed by Section 5.3.3E of the ASOP. These are the expenses that are reasonably spread over a number of years. In addition, expense margins in miscellaneous benefits can probably be subtracted. There are several places where most companies have expense margins: waiver of premium, accidental death benefits, substandard extra premiums, and modal loading factors, for example, may all have pricing margins that cover part of general expenses.

Removing those items yields net expenses. These net expenses then can be compared with expense allocations available in pricing. This can be done by taking the actual pricing factors on a policy form basis and multiplying by the units that correspond to those factors. The net expenses calculated can be then compared with the allowances and the expense factors for all the company products. Obviously, if the allowances exceed actual expenses, then expenses are fully allocated. If actual expenses exceed the allowances, however, then it's time to exercise some actuarial judgment.

Are the differences small? If actual expenses exceed the allowances by only 1% or 2%, it still might reasonably be concluded that expenses are being covered, especially if it's possible to go back a couple of years and show that pricing factors have generally covered expenses on an ongoing basis. Each illustration actuary will probably need to develop and document the tolerances for factors like these. For larger differences, however, it's likely that unit expense factors used in disciplined current scale testing will need to be increased to the point where expenses are reasonably covered. This sort of a framework should give some simple ways to develop fully allocated factors and should be useful as a basis for developing expense factors into the future.

This sort of framework, developed on a product-by-product basis, should give a good sense of how well your expenses are being allocated and should also allow for variation of expenses by product. It would seem reasonable for the actuary to vary expenses by product. For example, the pricing of multilife products should include underwriting costs for more than one life and those expenses should certainly exceed the expenses for single-life products. Term products, for example, may require less maintenance and the actuary could then allocate less expenses to term products.

The last question that I'll touch on for expenses is, What's the time period for recent historical experience? I would say one year, but I would temper that with judgment. If I thought the year was unusual for some reason, I'd attempt to make appropriate adjustments or to look back further.

Having gone into quite a bit of detail with the expense factor, I'll quickly talk about some other factor considerations.

MORTALITY AND LAPSE

Here again, it would seem appropriate to develop actual versus expected standard experience and go through a thought process similar to that used for expenses. Most companies will obviously not have credible mortality data over a short period, so recent historical experience might be three to six years. Lapse data tend to be more credible and a shorter period might be appropriate. Mortality is one area where you might want to pay some extra attention since most companies have tightened up their underwriting over the past few years because of AIDS and for other reasons. Experience on currently issued contracts may be expected to be better than experience on older contracts. This is one area where the mortality assumption underlying the disciplined current scale might appropriately be less than your pricing factors, if pricing factors are based on overall mortality.

INTEREST

It would seem reasonable to take the approach of either setting the interest rate or setting the interest spread as the assumption underlying the disciplined current scale. Probably a prime consideration is the attitude of the company towards interest rates. If changing interest rates on a regular basis over the course of the year is an important consideration, it would probably be advantageous to define interest spread as your assumption underlying the disciplined scale. If interest spread is defined, then that's another assumption that the illustration actuary will probably want to think about when comparing actual versus expected spreads.

With regards to taxes and commissions, the ASOP notes that commissions and other direct compensation should be directly charged. That indicates to me that you do not look at recent historical experience to determine actual versus expected commissions; you use the actual commission rates and formulas for direct sales costs. That would also seem to be a very reasonable approach to use for taxes. Federal income taxes can fluctuate from one year to the next and using actual tax rates and formulas in the assumptions would seem to be an appropriate method.

Let's turn to the self-support and lapse-support tests defined in the regulation. We've done a fair amount of testing of our products, and for various products they've probably tried a variety of methodologies. There seem to be two basic methods to test products and there are probably several variations of these methods. Bear in mind that the general approach for the illustration actuary will be to define the simplest method by which it can be shown that the product passes the lapse- and self-support tests. To name the first method, I'll borrow a term that I've run into: the illustrated point method. I’ll summarize the method: the actuary looks at the results of individual test cells to see whether the product is self-supported or lapse-supported. I expect that there are several ways to do this and I'll briefly comment on a couple of the ways. First, test cells should represent a majority of the business in force, and if all or most of those cells are self- supporting and not lapse-supported, it's probably a convincing demonstration that the product meets the requirements of the regulation.

The second method might be to prove that age ranges pass the tests. To use an example, the actuary might demonstrate that issue ages 25, 45, and 65 for a given underwriting class will pass the tests, and that pricing is consistent across that age range. It can then be concluded that all of the ages in that age range pass the tests. The illustrated point method has the advantage of simplicity. It's very easy to adopt this method from existing pricing cells. It's also very quick to produce results and can show where problem areas exist.

The other approach to testing would be a model office method. This method would develop a model of new issues for the policy form in question and demonstrate that the policy form passes the tests in the aggregate, as specifically permitted in Section 5.3.2. of the ASOP. What may be the simplest application of this would be to take the cash-flow-testing model, which is developed every year, and use the most recent year’s business model by policy form to test each form. One large advantage of this method is that it gives a better overall picture of whether and how the policy form passes the tests. When we followed this approach, it took much more effort to develop the original model for a given policy form, but it provided better data for analysis and allowed us to quickly shift distributions of business, which is useful if the actuary feels it is appropriate to shift distributions towards the portions that do not pass the self-support tests as defined in the standard.

A second useful advantage of a model office is that by calculating aggregate accumulated values of cash flows and comparing them with aggregate cash values, you picture the business as it will truly occur. Cells with excess cash flow over cash value will offset deficient cells. That also helps the problem that can occur at very long durations in the illustrated point method. At very long durations, there are so few survivors that individual cell testing can produce unusual results. You can see large positive or negative cash flows. A model office approach to pricing often reduces that problem.

RIDERS

Riders with nonguaranteed elements will need to be tested the same as base plans. In the testing we've done, we've tried to test riders that are an integral part of the base, along with the base plan. Riders that are expected to be issued on a more stand-alone basis, say a straight term rider of some sort, could also be tested independently.

On an overall basis, the illustration actuary will try to take as realistic a view of the testing as possible. Less time and effort should be devoted to products that represent a small proportion of the business. Products that have been priced recently with current assumptions should be tested fairly easily and quickly.

I'll conclude with a brief comment about annual certification. That's a topic that Deanne will discuss in more detail later. The regulation is silent as to when the illustration actuary is supposed to file the certification, but if the illustration regulation testing is performed based on the annual cash-flow-testing model, then it would seem appropriate to perform the illustration regulation testing shortly thereafter and probably file a certification in the first half of the calendar year.

Mr. Harris: The next speaker will be Jim Van Elsen. Jim spent 16 years as chief actuary for smaller insurance companies and recently set up his own consulting firm to consult for small companies. He's also a member of the Smaller Insurance Company Section Council and a member of the Academy Task Force on State Variations. Jim was heavily involved in the development process of the illustration regulation, including involvement in the ACLI committees as their small company representative.

Mr. James N. Van Elsen: My portion of the program will focus on small-company issues for the new regulation. Just out of curiosity, how many people here are members of the Smaller Insurance Company Section? OK, quite a number. Now, how many of you really work for small companies? Oh, it's about the same number. I was expecting to see a few more consultants or reinsurers. Also, just to clarify something, Tim had mentioned that I was chief actuary for a small company for 16 years. The majority of that time I was the only actuary and that's a situation very common in the smaller companies. I did a survey a couple of years ago by looking through the *Directory*. You'd be amazed by how many companies have two or fewer actuaries. There's an even greater number of companies that have no actuaries.

This is a brief overview of what I hope to cover in this short presentation. I will talk about when to begin working; those issues are different for smaller companies. I'll discuss small company aspects of the experience assumptions, documentation, and then make a few comments at the end.

The first thing I'm going to do is give you small company actuaries many good reasons to procrastinate. Most of the big companies, like The Principal, are well into their projects. They know for certain that they are going to be subject to the regulation, but there are a good number of smaller companies that aren't as certain. Many of them are only in a few states, and they don't know for certain that any of those states are going to adopt this regulation. They may very well not be subject to this regulation in the near future. In fact, one company asked me to be its illustration actuary but has told me, "Don't do any work until one of our states actually adopts it." It's hard to blame the company's skepticism about this, given the recent experience on Guideline XXX. Until the states actually adopt the regulations, many smaller companies aren't willing to begin the project.

Another factor is the GRET. The GRET has not been adopted by the NAIC yet and there is considerable expense to doing this project. It may be better to wait until you can see how the market evolves and how some of the issues evolve. If you're in a state like Texas or one of the other states that are considering significant variations, why not wait until you're certain about what you're going to have to do? What is the cost of not being ready in time? If you aren't prepared or if your company isn't prepared for this new regulation when it becomes effective in one of your states, your field force could find itself in a situation where they can only illustrate guarantees. What's the cost of that to your company? Do not underestimate the time it's going to take to implement this regulation. There will be much programming time. There will be significant actuarial studies that need to be completed and many of my clients have discovered that it was necessary to modify their products in order to remain competitive in the new market. All of this is going to take a great deal of time.

Finally, when you're in a panic at the end of the year getting all your requirements completed, every other company will be panicking too. If you need consultant help, it will be scarce in the last quarter, in my opinion. If you need products approved, it's very likely the states are going to be swamped with new filings. So, if you're not absolutely certain that you won't be affected by this regulation, I would encourage you to get started.

MORTALITY

I'm going to cover the experience assumptions very quickly from a smaller company point of view regarding mortality, expenses, and persistency. The ideal is that you have a recent credible mortality study of your own experience. Of all the small company actuaries in the audience, how many of you have one of those? There are a couple, but it's certainly the minority of the smaller companies. In most cases, smaller companies are going to be using some modification of an industry study.

Using an industry study does not absolve the actuary from demonstrating the reasonableness of the assumption. I would suggest documenting the rationale for the assumption. You might include a review of your underwriting standards, marketing areas, persistency results and your reinsurance quotes, anything that would tend to help support your rationale for your assumption. I'd also suggest that you do an aggregate comparison of death claims expected from your assumption to those you've actually recently experienced. While one year may have significant variations, you may be able to find support for your assumption with the trend of several years.

EXPENSES

Most companies still do a classic total functional expense study, right? Not likely. You must do some expense study. If nothing else, some companies are doing an aggregate study, just using the information in Exhibits 5 and 6 of the annual statement, coupled with policy data from the policy exhibit. Whatever method you use, be aware that the requirements of *ASOP 24* state that indirect costs should be allocated using a sound basis of expense allocation.

After setting your assumptions, test them in aggregate against the most recent year. I would also recommend that you review, very carefully, your average size assumptions. These can affect the results very significantly. If you intend to use fully allocated expenses, that is all you need to calculate. You are always allowed to use fully allocated expenses. If you are considering using the GRET, however, you must also calculate appropriate marginal expenses.

The GRET may be used if it produces expenses greater than marginal expenses. If the marginal expenses are higher, you must use an assumption at least as great as those marginal expenses. That's why you have to calculate them. Once again, you can always use fully allocated expenses. Whatever method you use must be disclosed to your agents. For some companies, this may not matter. For others, this could become a key competitive issue, and this is something you'll have to consider when developing your expense assumptions. Finally, you must use the same method—fully allocated, marginally allocated or GRET—for all your products. You will need to determine which distribution is appropriate for each of your products. It's possible that a company may use more than one distribution system, so it would be expected to use whichever of these is appropriate by product. Some deviation from this table is possible, as long as the actuary ensures that total expense assumptions used reproduce the GRET in aggregate.

The last point is, if you do use the GRET, you must add direct sales costs and federal income tax and state taxes to those expenses. The status of the GRET, to my understanding, is that it will be submitted to the NAIC in June 1996 in New York, and I believe Tim is responsible for that.

Mr. Harris: That's right. The status is a little unclear at this point. We thought things were going smoothly but there has been a snag. I'll know more later, and I do plan to be at the New York meeting with the Life Disclosure Working Group to discuss the table.

Mr. Van Elsen: If all goes well, it could be adopted by the NAIC either in October or December of 1996.

Mr. Harris: Right.

Mr. Van Elsen: That's if all goes well.

Mr. Harris: Probably December is more realistic.

Mr. Van Elsen: A number of organizations in the states that are adopting early are hoping that the individual commissioners may adopt the table for use in their states. So, if you're intending to use the GRET, this is the best we have at this point, but obviously until it's actually adopted it can change.

PERSISTENCY

This is the last assumption I'll be discussing. Again, it's best if you have actual experience to support your assumptions. Be sure to take into account product-specific events. If premiums increase 50%, higher lapses probably will be expected. Conversely, lapses will probably be low just prior to a large bonus.

I can't overemphasize this. Years from now, your work will be subject to review by regulators and plaintiff attorneys. You must document your work and in documenting, be sure to review the requirements of the ASOP. They are specific and are contained in Section 6.3 of the ASOP. Be sure to develop a logical development of your assumptions. Once again, some day, someone else may be reviewing this for reasonableness. If you don't have actual studies, try to provide other evidence, such as actual-to-expected studies. Finally, you must document how your products pass the lapse- and self-supported tests. Keeping current on this regulation will require much effort. You must pay attention to the activities in this area. There are a few sources for staying current. I also expect the trade organizations, such as the ACLI and the National Association of Life Companies (NALC), to try to keep their membership current.

Finally, my brief editorial. Essentially, the success of this regulation is going to depend very much on how agents, actuaries, and other company officers conduct themselves. Hopefully, it will be in a very professional and ethical manner.

Mr. Harris: I have a couple of comments before we introduce our next speaker. There has been a difference of opinion between the Life Research Committee and the representatives of the NAIC regarding the GRET. The Life Research Committee is leaning toward the multiple tables for different distribution systems, and the NAIC is leaning toward one table for all companies. That's an issue that has to be resolved. In addition, some other comments were made that may result in slight changes in the final factors of whichever table we end up with. Another point to keep aware of is that you do have continuing education requirements if you're going to be certifying as an illustration actuary. They're not going to be as focused as valuation actuary requirements, but you are going to have to keep a log of illustration-related meetings and general life insurance meetings that you've attended or education that you receive that could be applied toward continuing education requirements.

With those comments, I'm going to introduce our next speaker, Deanne Osgood. Deanne has 11 years of experience in the life industry with a concentration in life and annuity product development. She is recently with Milliman & Robertson and this is one of a series of presentations that she has made on the illustration issue. She's quite knowledgeable in the area, especially as it relates to product development.

Ms. Deanne L. Osgood: I am prepared to discuss several miscellaneous topics very briefly, hoping to promote some thought and generate some discussion as we will begin the discussion period immediately following my remarks.

The NAIC Life Insurance Sales Illustration Model regulation was developed to address some of the issues that have been highlighted as market conduct issues, to keep pace with changes in the economy and life insurance product development over the past decade, and to improve agent and consumer understanding of life insurance products. The goals of this regulation are to ensure that illustrations do not mislead customers who purchase life insurance, and to make illustrations more understandable. The model regulation contains many requirements designed to improve company illustrations, improve customer disclosure, and improve company documentation procedures.

The model regulation will impact many aspects of the life insurance business. I will briefly discuss some of the various impacts that the model regulation will have on the product development process. Specifically, I will discuss the impact that the model regulation will have on product design and management, the format, content and use of illustrations, and the certification and documentation responsibilities of the illustration actuary. If time permits, I will also discuss the impact that the model regulation will have on the sales and administration processes.

ASOP 24, which defines compliance with the model regulation, requires each form to pass the self-support test and the lapse-support test. A policy form passes the self-support test if, for all illustrated points in time after the fifteenth anniversary (the twentieth anniversary for multiple-life policies), the accumulated value of all policy cash flows equals or exceeds the total value available to the policyowner. The lapse-support test requires the policy form to be self-supporting under a modified persistency assumption using the persistency rates underlying the disciplined current scale for years one to five and assuming 100% persistency thereafter. All other assumptions are the same as those underlying the disciplined current scale, which are also used in the self-support test. Some policy forms that have no guaranteed or nonguaranteed nonforfeiture values at any duration, such as certain term coverages, are exempt from the lapse-support test. The illustration actuary may test the policy form under various underwriting classifications such as age, sex, and risk class, and policyowner choice factors such as premium payment pattern, size of policy, and so on. The tests may be passed in aggregate.

The requirement to pass the tests will have a significant impact on product design. For example, persistency bonuses may be eliminated, reduced, or moved to later policy years. These bonuses may include interest rate bonuses, a refund of cost of insurance charges, a refund of premium loads and so forth. Also, commission patterns may become more level, enabling policy cash flows to accumulate more quickly, which in turn may enable a policy form to pass the tests.

As a result of the model regulation, guaranteed cost of insurance and expense charges may be decreased, and guaranteed interest rates may be increased to improve the illustrated guaranteed values. The model regulation may shift the competitive focus of products to be on years 5, 10, and 20 and age 70, which correspond to the years that are required to be illustrated on the numeric summary of the illustration. Finally, companies may evolve to products that are exempt from the model regulation. For example, term and annuity combination products may emerge again because term products may be exempt from the lapse-support test requirement and annuity products are not subject to the model regulation. The model regulation for annuity products is not too far off, however.

Companies and agents also may evolve to variable products because variable products are not subject to the model regulation; however, the illustrations for variable products are subject to requirements established by the SEC and probably will become subject to an illustration regulation comparable to the model regulation. Therefore, even though I've heard that some companies may evolve to products that are exempt from the model regulation, I don't think that it is a likely impact of the regulation.

I would like to spend a few minutes discussing the impact that the model regulation will have on the format, content, and use of point-of-sale and in-force illustrations. The model regulation does not prescribe a standard format for the illustration, but rather it prescribes a standardized progression of elements for the illustration. I think it is safe to say that every company that uses illustrations will have to modify their illustration systems. Many companies that I've spoken to are planning to outsource this task, and I am aware of several software development firms that have created illustrations that they feel comply with the format requirements of the model regulation.

Illustrated values will be limited by the model regulation in that they cannot exceed the values generated by the disciplined current scale, as certified by the illustration actuary, or the currently payable scale for a given policy form. For example, a company will not be able to illustrate increasing interest rates unless the generated values are less than or equal to those generated using the disciplined current scale. A company may decide to illustrate values based on the certified disciplined current scale and then provide a point-of-sale disclosure if they're actually applying a more favorable scale in practice. I saw a disclosure that said: "This policy is currently being credited with interest in excess of that being illustrated. The company is prohibited by law from illustrating values based upon current practices as these values result in the policy's failure to meet statutorily mandated minimum projected profit objectives."

Some companies may decide not to illustrate some policy forms. I am aware of one company that was not going to illustrate a single-premium life product until it received an opinion that the process of quoting a nonguaranteed interest rate constitutes an illustration and is therefore subject to the model regulation. Now it is working with a software development firm to develop a point-of-sale illustration for that product. Finally, for the first time, companies are required to provide an in-force illustration upon request from a policyowner. The in-force illustrations must comply with various requirements of the model regulation.

Before I move on to discuss the illustration actuary, I would like to mention one product management issue. Point-of-sale illustrations for new policies must reflect actual current practice for in-force policies of the same policy form. For example, if a policy form has in-force policies that have achieved the requirement to receive an interest rate or other persistency bonus, and the company is not paying the bonus, then the company cannot illustrate the bonus for new policies using that policy form. To be able to illustrate a bonus, the company would need to file a new policy form.

The model regulation created the “illustration actuary” who is responsible for certifying that the disciplined current scale conforms with *ASOP 24* and that the illustrated scales used in the illustrations authorized by the insurer meet the requirements of the model regulation. The illustration actuary must file an actuarial certification that contains disclosure statements that address five issues.

The first issue is whether the currently payable scale has been reduced since the last certification for reasons unrelated to changes in experience. This disclosure applies to policies issued in the previous five years and within the scope of the certification.

The second disclosure requirement is whether there are any inconsistencies between illustrated nonguaranteed elements for new policies and for similar in-force policies. For example, the illustration actuary should provide disclosure if the company is illustrating a bonus for new policies of one policy form, but is failing to actually pay the bonus on in-force policies of a similar policy form. Therefore, if a company is not paying a bonus on an in-force policy form and the company is illustrating the bonus on a new policy form, the inconsistency would have to be disclosed in the actuarial certification.

The third disclosure concerns whether illustrated nonguaranteed elements for new and in-force policies are consistent with nonguaranteed elements actually applied to the same or similar forms. The illustration actuary must disclose the method used to allocate overhead expenses. Finally, the illustration actuary may rely on data supplied by others and if so, the illustration actuary must disclose such reliance in the actuarial certification.

The actuarial certification is filed with the board of directors and the state insurance commissioners. It is filed annually for all illustrated policy forms and before a new policy form can be illustrated. As previously discussed, the date of the annual filing is determined by the company. The certification date does not need to coincide with the annual statement filing. If an error in a previous certification is discovered, the illustration actuary is required to file a summary of the findings and also file an amended certification. The amended certification is filed in addition to the standard actuarial certification. Therefore, if an amended certification is filed, the illustration actuary also should file the standard actuarial certification on the filing date that was determined by the company. It is possible that the illustration actuary may be unable to certify the scale that an insurer intends to use. If this situation occurs, the illustration actuary must notify the insurer's board of directors and the insurance commissioners promptly.

Some people think that one potential impact of the model regulation is that there will be more lawsuits filed naming the illustration actuary. By design, the model regulation does not offer protection from personal liability to the illustration actuary; however, I am aware of a few actuaries who will be appointed as the illustration actuary for their companies who have asked for some kind of errors and omissions (E&O) or similar type of coverage.

The illustration actuary should maintain documentation supporting the certified disciplined current scale. The documentation should include the description and rationale for the mortality, interest, persistency, expense, and tax assumptions, as well as the description and rationale for other calculations and assumptions used to perform the self-support and lapse-support tests. The documentation should include a description of the methodology used to allocate interest credits and a demonstration that the self-support and lapse-support tests have been met.

The responsible company officer, who must be someone other than the illustration actuary, also must file an annual certification. This certification should include statements that the illustration formats meet the requirements of the model regulation; the illustrative scales are those scales that were certified by the illustration actuary; the company has provided the agents with the expense allocation methodology; and the expense allocation methodology is disclosed in the actuarial certification. As you can see, the illustration actuary and the responsible company officer have to work together very well.

Finally, I would like to mention a few of the impacts that the model regulation may have on sales and administration processes in life insurance companies. Virtually every company will have to design or modify a point-of-sale or in-force illustration system. Many companies provide in-force illustrations today. Some have a formal process, while others provide in-force illustrations on a more manual or ad hoc basis. Therefore, some companies may need to design in-force illustrations and design processes to prepare and deliver in-force illustrations to policyowners.

In-force illustrations are not required by the model regulation until the policy has been in force for one year. This implies that a company will have until January 1, 1998 to design an in-force illustration system and the processes to comply with the model regulation. In reality, however, a company that back dates policies may have to have an in-force illustration system and processes in place before January 1, 1998 because the model regulation applies to policies with issue dates of January 1, 1997 or later, regardless of the effective date.

Companies will need to develop a process to determine when a policy is issued differently than applied for and illustrated at point of application. They will also have to design a process to prepare and deliver a revised basic illustration corresponding to the policy as issued. Some companies that I have spoken with are planning to do this in-house while others are considering delegating this responsibility to the field.

For a period of three years after a policy is no longer in force, a company will need to retain signed copies of all illustrations used and any forms certifying that no illustration was used. These processes are going to have to be designed.

Companies will have to develop the annual certification forms and the forms certifying that no illustration was used at the point-of-sale.

Finally, companies will have to ensure that they have made a good faith effort to deliver a basic illustration to the customer that corresponds with the issued policy. This applies to direct response business, as well as revised basic illustrations.

At this time, Tim Harris will facilitate the discussion session.

Mr. Harris: What we're going to do now is try to get some audience participation. As I indicated earlier, my experience has been that there are many questions that people have about the illustration regulation and ASOP.

Mr. Thomas J. Mitchell: A real basic time frame question. Suppose a state adopts it January 1, 1997 and I choose July 1 for the company date. Am I filing the certificate by July 1 or sometime after, and is it certifying that things going forward from July 1 are OK, or that everything for the past year, which would be six months is OK, or both?

Ms. Osgood: This is a question that has been asked several times and one that I've heard different answers for. I will give my thoughts and then open it up for anybody else to comment. I think I would file one by January 1, 1997 and go on a prospective basis; however, I know some companies are planning to take a retrospective approach.

Mr. Phillips: This is something that we've talked about in the Practice Notes Group, and we haven't really come to any conclusion. You can take the perspective that it is a retrospective certification that what you've done has complied with the regulation. You can take the perspective that it's a snapshot of what you are doing right now as complying, or you can take the perspective that you're looking forward. Tim, I don't think we've really come to any conclusion on that.

Mr. Harris: I don't think we have.

Mr. Thomas L. Bakos: Isn't the illustration actuary required to certify that the dividend scale that is being used in illustrations is, in fact, a disciplined current scale? It would seem to me that you would have to do that certification prospectively. In other words, you can't illustrate a scale that's not a disciplined current scale, and if you wait until halfway through the year to do your work and it turns out it's not a disciplined current scale, then don't you have a problem?

Mr. Van Elsen: At the very least, it would seem that you would want comfort, as the actuary, that the illustration that's going to be used is actually going to comply. Even if the certification isn't done at that time, you'd want to be establishing your disciplined current scale up front, I believe. So, whether the certification is done retrospectively or prospectively, I think the work is going to need to be done at the beginning of the year. Is that consistent with you?

Mr. Phillips: I think that the ASOP says that you have to have a disciplined current scale that passes the test and that you have to be not illustrating a scale greater than that. That's a slightly different perspective.

Mr. Horace G. Johnson: I was recently listening to the audiotapes of the ACLI illustration actuary meeting and this question was raised in the context of a company offering a universal life policy in which they adjusted their credited interest rate monthly. The question was: "Would you have to recertify every month when you changed interest rates?" Some of the lawyers on the panel at this seminar answered that the certification was intended to be retrospective in nature and that you were certifying that all that you had illustrated over the past year complied. That was an answer that was put forth at that seminar.

Mr. Van Elsen: Even though you're certifying retrospectively, as an illustration actuary, I would like to have some comfort at the beginning of the year that the scale they're going to use is appropriate. I'm going to do my work at the beginning of the year and then perhaps certify it at the end of the year.

Mr. Robert P. Marks: My question is with regards to payroll deduction life insurance, and I seem to recall one provision in the regulation that stated that there is an exception for having a certified illustration or an illustration that complies with this law. Can you actually give a quote, as opposed to an illustration at the point of sale, and then give a certified or a required illustration no later than the delivery of the policy itself? Could you comment on what constitutes a quote? For example, can they show some values on a screen without a handout? Is a quote a rate-card-type illustration?

Ms. Osgood: I believe that a quote would be based on a reasonable age and reasonable face amount for the group that is applying for coverage. I seem to recall that if the employee is going to be paying the premium or applying for more coverage than what the employer would provide, then an illustration would need to be provided at the point-of-sale, specific to what that employee was considering. Or if the employee requests an illustration at the point-of-sale, one would need to be provided as well. Other than those two situations, I believe that a quote could be used, based on reasonable assumptions for the group.

Mr. Marks: If it's payroll deduction individual life and the employee is actually paying the cost of the premium without employer involvement, although there is some inherent sponsorship by the employer, does it not follow that that exception applies?

Ms. Osgood: I think an illustration should be provided.

Mr. James D. Atkins: I believe this issue says that you can give them a generic illustration, not just a quote of a price and face amount, but it's a regular illustration, but for a sample case for the group. It's a full-blown illustration for a hypothetical person at the point-of-sale; then give them the illustration delivery.

Mr. Roy G. Shrum: I guess my question is, do you even have to give a quote in an employer situation like that, or can you just wait until the sale and say your rate is *x* dollars for so much coverage?

Mr. Van Elsen: That sounds like a quote.

Mr. Shrum: Let me differentiate. In my mind, if I say that I'm going to charge you $0.15 per 1,000 for how many thousand you want, there's no projection of any values of any kind. It's just this year's rate, and it would be guaranteed through an employer agreement so you're just giving them guaranteed values with no projection. I don't know if that's a quote. I don't think you need a full-blown illustration in that situation.

Mr. Van Elsen: First of all, if you're providing just guaranteed values, you have no illustration. An illustration has to have a nonguaranteed value. The exception is in Section 5D, and it pertains to nonterm group life. It says you may provide a quotation that shows potential policy values for sample ages and policy years on a guaranteed and nonguaranteed basis appropriate to the group and the coverage. You're providing sort of an illustration to show a group of employees how this product will work. You're not really focusing in on an individual. That's what was intended in this exception.

Ms. Nancy L. King: What constitutes the point of sale? We have at least one policy form that's indeterminate premium. We show both current and guaranteed premiums. Is that an illustration? Is the cost and benefit summary that's included an illustration? We sell primarily direct response, so we don't illustrate it up front, at the point of sale, and that's our way to show them some information.

Mr. Van Elsen: The first half is easy. Anything that shows a nonguaranteed element is an illustration.

Ms. King: Even after the contract has been issued?

Mr. Van Elsen: This is one of the areas where we have conflicts between some of the state laws that require the disclosures and the illustration regulation. I would say you would have to provide that disclosure and that would override this.

Ms. Osgood: The basic illustration is required to be delivered with the policy as issued in direct-response business.

Ms. King: That's if you're illustrating though, right?

Ms. Osgood: Yes. Are you going to illustrate the policy form?

Ms. King: If I were to say no, we're not going to illustrate it, then do I have to?

Ms. Osgood: If you're not going to illustrate it, then I don't think you'd want to be sending any information that contains nonguaranteed elements.

Ms. King: Can you show them current values?

Ms. Osgood: No.

Ms. King: You can never answer questions over the phone, such as What are the values after that ten years? You can't provide that customer service for a whole year?

Ms. Osgood: Customer service before it's issued?

Ms. King: Or after, because isn't there something through the first policy anniversary that you can't illustrate this at all until the first policy anniversary?

Ms. Osgood: Well, that's when it's required. In-force illustrations are required by the model regulation after the first anniversary. But the model regulation does not apply if you are not going to illustrate the policy form.

Mr. John B. Yanko: Is pre-need life insurance excluded from this regulation?

Mr. Van Elsen: No.

Mr. Yanko: Commissioner Wilcox, at a meeting in Dallas, said it was excluded, though it's not in the final wording. Can you use any type of literature of previous hearings that weren't included in this final draft?

Mr. Van Elsen: There is a provision that exempts any policies with face amounts of $10,000 or less. So, if you have any $8,000 death benefit with cost-of-living adjustments and it gets you up $10,000, you are not exempt.

Mr. Yanko: Right, the $10,000 limit is not determined at issue, it's at any point in time then.

Mr. Van Elsen: That's right. My understanding is that the pre-need companies are not exempt. A number of companies I know just intend not to illustrate. I guess many of your illustrations go to the producers anyway, instead of the ultimate client, and that is another issue.

Mr. Yanko: Right. We have several companies with the idea that their customer is not the final consumer, so they do not provide illustrations.

Mr. Marks: Another question I have is with regard to cost disclosures that states require. They typically are on a current projection basis and guaranteed projection basis and that will be inconsistent with the values that will be illustrated at the point of sale. Is there any talk about doing away with cost disclosures since these illustrations will now be required?

Ms. Osgood: I have heard that the regulators are recommending that the Illustration Model regulation supersedes any Cost Disclosure Regulation for all illustrated policy forms. Any policy form that is not subject to the Illustration Model regulation would continue to be subject to the Cost Disclosure Regulation. This may not happen and it could vary by state, but I have heard that this is the recommended approach.

Mr. Van Elsen: This will be one of the many state exceptional items that you'll need to keep track of during this process. One thing I can't overemphasize is as you go through this year, keep track of what's going on in the states that concern you because of these kinds of issues.

Mr. William E. Wilson: I have a question about the disciplined current scale expense assumptions. Does the actuary need to make an assumption about the inflation of expenses for purposes of doing the self-support tests and the lapse-support tests?

Mr. Van Elsen: I don't think there's anything in there about inflation of expenses. You certainly may if you feel like expenses are going to go up in the future and you want to take into account higher expenses. You may, but I don't think there's a requirement in there that you do.

Mr. Wilson: You don't have to?

Mr. Van Elsen: That's my understanding, yes.

Mr. Harris: That's an issue that we addressed when we were developing the numbers for the GRET. Some of the Life Office Management Association (LOMA) data that were provided to us indicated that, if anything, life insurance expenses had been declining over a period of time, but we're not sure if that's real or not because of some of the allocation problems within companies. Because of the shift to more annuity premium, we thought that there might just be misallocation of expenses more toward the annuity side, detracting from the life side, and in turn, resulting in lower expense factors. So, some of the industry data indicate declines, and we haven't provided for any inflationary adjustments of the GRET.

Ms. Osgood: One of the things to consider is that you're going to be reviewing your recent historical credible experience. When you're doing an expense study, you're going to be basing it on actual recent experience, and if your experience indicates that inflation should be recognized, even though it's not directly addressed in the regulation, you probably would want to recognize it in the disciplined current scale because it is warranted by your experience.

Mr. Wilson: I didn't agree with that. I'm just wondering, is there a deficiency in the actual ASOP, in that they should have had something in there addressing that point and requiring the actuary to address that issue?

Mr. Harris: I think that's something with which we're now trying to cope. It's one of the many, I don't know if I want to call them deficiencies, unanswered questions in the regulation and the ASOP. The issue of inflation is probably another one, but that's something that the Practice Note Group is trying to address. Many times, we went back to members of the Life Committee of the ASB and asked them, What did you really mean when you said this? or Were you thinking about this when you said that? or Did you consider this item? We have to go back to the source to some of the people who put together these documents and find out what they were thinking or how they might handle this issue.

Mr. Van Elsen: It is covered somewhat in the ASOP, in 5.3.4.B. It says, if trends indicate that significant and continuing deterioration in an experience factor—now I assume that would include expenses—has occurred, or, in the actuary's judgment is likely to occur between the date of historical experience and the effective date of the scale underlying, that you should recognize such deterioration. It's very cloudy and I know some actuaries are going to interpret that the way you're saying and some are not.

Mr. Wilson: I think it's something far broader than that. I'm not just talking about inflation to the point at which the illustration is made; inflation for year after year in the future is really the issue.

Mr. Van Elsen: Sure.

Mr. Harris: That's a good question and that's one that we'll have to add to the list.

Mr. Phillips: I agree with that, Tim. The illustration actuaries are going to have to think about what's going on at their companies and determine some reasonable approach to defining the answers to these questions. I'm not sure that anyone is going to have a great answer. You're going to have to use a great deal of judgment.

Mr. Bakos: It just occurred to me that that sounds like projecting; if you're using inflation in your expense assumption, aren't you projecting future expenses?

Mr. Phillips: You can project deterioration. You cannot project improvement.

Mr. Bakos: Well, do you think anybody actually would?

Mr. Phillips: I'm just telling you what it says.

Mr. Bakos: I have another question. On the requirement that the illustration actuary disclose whether a dividend scale has changed for reasons other than changes and underlying experience, my assumption is that, with respect to the implementation of the NAIC standards, such a disclosure only has to be made with respect to say, a January 1, 1997 date and thereafter. In other words, if the model is effective for a company and as a result of the model becoming effective they have to reduce their dividend scale because what they were using before was not disciplined, then they wouldn't have to disclose that, at least initially. Is that a correct assumption?

Mr. Van Elsen: I believe it would be because you did not have a disciplined current scale before.

Mr. Bakos: So you would be reducing your dividend scale to make it disciplined, but not for reasons that are related to an actual change in underlying experience. If you did that ten years from now, you would have to disclose that fact.

Mr. Van Elsen: That's right.

Mr. Bakos: But if you do it at the initiation of the model regulation, then you wouldn't have to disclose it.

Mr. Van Elsen: That would be my opinion.

Mr. Bakos: Tom Phillips seemed to think that many companies would actually be illustrating dividends less than in a disciplined current scale, and I think that would be a rare occurrence because it seems that the NAIC model was being implemented primarily because of the belief that many companies were illustrating dividends higher than the disciplined current scale. Let's assume that you do have a company that is, ten years from now, illustrating dividends that are less than a disciplined current scale for it. In the following year, it decides to increase its dividends to the then-current disciplined scale. That change has nothing to do with the change in underlying experience, so I assume it would have to disclose that fact. Conversely, what if you went the other way, and were using a disciplined current scale and decided to be more conservative?

Mr. Phillips: I would anticipate that you would have to file something at that time. Just a word of clarification: with a disciplined current scale, you can take the approach that it is kind of a maximum no-profit dividend scale. That's what you can afford to pay out as a maximum and not make any money. You can take that point of view and at any time, you can decide to set your factors less than that.

Mr. Bakos: That gets to my other question now, because if you're paying a disciplined current sale and it's disciplined because it includes no profit, it doesn't seem to me you could go on doing that for a very long period of time. At some point, you have to introduce profit and when you do that, you'd have to disclose the fact that your dividend scale changed for reasons other than changes in underlying experience, but just because you decided to take some profit. If you make a conscious effort to change your profit, you would probably end up having to disclose that.

Mr. Phillips: I think that's correct. I think that is the one factor that would cause you to have to file that statement, if you made a change in your profit factor. It seems like everything else is an assumption underlying the disciplined current scale.

Mr. Shrum: Mr. Van Elsen, you mentioned that keeping track of the states would be important. Are there any plans for keeping us posted somehow, perhaps by using Actuaries Online?

Mr. Van Elsen: I know there are a number of people, as they find out, who hopefully will post it on Actuaries Online. I'm hopeful that there will be coverage of it in the trade publications, like the *National Underwriter* and such. Talk to your consultants. The ACLI and the NALC hopefully will keep their companies up to date. It's going to be a challenge for the actuary in this whole process to keep up. At this point, I'm only aware of North Carolina adopting it, but there are a number of states that are close. If all else fails and you're in just a few states, I'd call the departments.

Mr. Harris: You always have the NAIC manual, "Model Laws and Regulations," which would keep you updated on which states have adopted the model regulation, and it also indicates which states have any deviations. It doesn't tell you what the deviations are, but it indicates whether or not they have deviated from the model regulation. It also cites the location in the state laws. You might have to do a search on it to find out exactly what's going on. The NAIC is always your best bet. They should be willing and able to answer your questions.

Mr. Timothy A. Ryor: I guess I'd like the panel's thoughts on the likelihood of the actuary being held responsible for the values shown in the illustration. Is that a real concern that we should focus on, or is that something that's not a real issue?

Mr. Van Elsen: I'm going to conduct myself as if I might be. It's hard to say, you know, plaintiff attorneys haven't found action against actuaries before, but that doesn't say that they won't.

Mr. Harris: Plaintiff attorneys have found action against actuaries, just not to the extent that they have found action against CPAs.

Mr. Van Elsen: Obviously there is exposure and I would suggest you conduct yourself as if you'll be the number one candidate.

Mr. Harris: There's possibly more exposure here than there was for the valuation actuaries because there's already ongoing litigation over some of the vanishing premium information that was provided in the past. I'm sure many of you are aware of some of these cases. You've seen the press on them or you may work for companies that have been sued. These class actions suits are policyholders who know that interest rates have dropped and have found that their premiums hadn't vanished as they were told they would, so that's the type of case where the attorneys are going to be looking for any pockets they can find, whether it's your company's deep pockets, your own homeowners policy, or any assets. I don't know if they can go after you individually. They may be able to. I'm not sure. You'd have to check with an attorney. Follow the ASOP and the regulation. Also, I highly recommend getting your hands on the Practice Notes if you're going to be signing as an illustration actuary. One of my concerns is that we have Practice Notes that people may not be looking at, which in a court of law could be used against you. Read the ASOP; read the regulation and get your hands on the Practice Notes and do what the profession says you should be doing. That's all you can do.

Mr. Delmer F. Borah, IV: I heard if you wanted to develop a single illustration format to use nationwide that you might have problems in some states. If you developed one nationwide and it complied with the model and they had not adopted the model, they might have an existing regulation that meant you could not use something that complied with the model. I wondered if anybody had anymore information about that?

Mr. Van Elsen: I think that's quite possible and you may also have states that adopt some version of the Model that change what it looks like. I know one draft that Texas has come out with does specify exact format. Again, you're going to have to keep track of each state and what's going on there. There are existing regulations on what illustrations have to look at and until they've been repealed, they exist.

From the Floor: With respect to the effective date of January 1, 1997, is that the effective date for all policies issued after January 1, 1997, or for all policies illustrated after January 1, 1997?

Mr. Van Elsen: It is effective for all policies sold on January 1, 1997 and thereafter.

From the Floor: For example, if it was illustrated in November, but the issue date was January 1, 1997, in November we will not be required to have the new format in the states that require it, or did I misunderstand?

Mr. Van Elsen: That would be my understanding.