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Professional Standards Affecting Life Actuaries

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Summary: Learn more about potential standards of practice being considered by the Life Committee of the Actuarial Standards Board (ASB). Topics to be discussed will include possible standards relating to demutualizations and to changes to nonforfeiture laws.

Mr. William C. Koenig: Over the last 12 years, the ASB and its predecessor, the Interim ASB, have been trying to codify the proper way for actuaries to go about their work. They are doing a great service and are helping to turn the actuarial occupation into a real profession, not just a group of people who do the same job.

Frank Irish retired as the chief actuary of the John Hancock after a 31-year career, spending many years as director of planning. He started his first term on the ASB in 1994, and now will be starting his second three-year term. He is one of the three members with primary life insurance responsibility.

Tom Foley is chief actuary at the state of North Dakota. Tom has done it all. He has worked for a big company as an actuarial trainee in the early 1970s; he has worked for small companies where he has been chief actuary; he has been an agent; and he has been a regulator not only in North Dakota, but in Florida as well.

Mr. Frank S. Irish: One of my main functions is to give you some background on the ASB. It is only about a dozen years old, as Bill pointed out. In those dozen

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years, it has created 24 actuarial standards of practice (ASP). The ASB is an organization that operates within the aegis of the AAA. The AAA supplies the administrative support but otherwise the board is independent. The board is responsible only to the profession as a whole.

We are talking mainly about the life practice functions of the ASB. I would say in the life practice area the structure of standards is more complete than in the other areas of practice.

You are familiar, I hope, with most of the standards that affect life actuaries in the fields of pricing and illustration practices.

There is *Standard No. 1* on nonguaranteed elements, *Standard No. 15* on dividends, and *Standard No. 24* on illustrations. In the field of reserving for life insurance, there are *Standard No. 7* on cash-flow testing and *Standard No. 14* on cash-flow testing; *Standard No. 22* on asset adequacy analysis, and Actuarial Compliance Guideline No. 4 on complying with the asset adequacy regulation. In addition, there are several other standards that affect life actuaries: *Standard No. 10* on stock life GAAP, *Standard No. 11* on reinsurance, and *Standard No. 12* on risk classification.

When the ASB decides to start a project on a particular topic it looks for suggestions from many different points of view. The board will accept suggestions for new projects from any source. There are several principal sources for new projects at the ASB. One of these is the Life Committee, which has among its responsibilities the charge to continually review its field of operation and to see if standards are needed in any particular area. The other operating committees are similarly charged to review their fields continuously. Therefore, when gaps are discovered, new standards are created. As an example, *Standard No. 21* on relations with the auditor and *Standard No. 19* on appraisals were created when it was discovered that there was a need for these standards.

A second major source of new projects for the ASB is the regulation process or regulatory pressure. When the regulators come up with new model laws and model regulations that are going to make major changes in how life actuaries practice their occupation, the ASB has the duty to respond with a standard on how the actuary should comply with those new regulations. Two recent standards in the life field are *Standard No. 22* on asset adequacy analysis, which was passed in conjunction with the new regulation on that subject, and *Standard No. 24* on sales illustrations. You are going to hear more about those two standards because those are the big things that have happened in the life practice field in the last few years.

The goal of the ASB in writing a standard is to codify what is good practice. We have a saying on the board that when we write a standard we try to raise the bar. That is, we try to do something that will eliminate some of the worst practices of today and will codify some of the best practices of today, and raise, in general, the minimum standard of ability and good practice on the part of actuaries.

There are, however, some severe constraints that prevent us from going much further than that. Many of us, myself included, would like to do some radically new things. But we have to be aware that the ASB is a private organization and is subject to antitrust laws and other legal burdens. The board cannot radically change actuarial practice. It can look at what actuaries consider to be good practice and try to incorporate that. The value of having written standards that incorporate good practice as compared with having unwritten standards, I think, is tremendous.

There are two areas where the board has to tread very carefully with regard to antitrust laws. One area is pricing. Many of the standards have been designed so that, although they seem to refer to pricing, they are actually about ratemaking procedures or documenting actuarial procedures. Some of the standards do touch on pricing, but very carefully.

The board also does not want standards of practice to be seen as interfering with the ability of actuaries to carry out their occupation. Noninterference is more of a concern than with some other fields where there are independent practitioners, particularly the pension field where one can easily get into that bind. Most actuaries want to use and exercise independent judgment. They do not want someone telling them how to practice their profession. In many cases, the ASB tries to word standards generally enough so as not to be seen as infringing too greatly on an actuary's independence of judgment. That is a philosophical issue, one of many that we discuss on the ASB. I favor more detailed, specific, and directive standards, but others would prefer to let the actuary exercise more independent judgment.

There is one situation where the board does something radically different from anything that is in today's practice. That happens when the regulators take the lead. When new regulation is put on the books, the ASB can follow the lead of the regulators and show actuaries how to comply with this new regulation. Frequently, as is the case of both of the standard on asset adequacy and the standard on illustrations, the life actuaries experience radical changes by virtue of the new regulations. The standards that went along with these regulations were similarly radical in nature.

Departure from the past practice of avoiding antitrust laws can only happen when the regulators take the lead. The ASB cannot make these changes by itself.

It is worthwhile describing the process that the ASB goes through in developing and adopting a new standard. The ASB has nine members and eight subject area committees reporting to it. Of course, the one of principal interest currently is the Life Committee, which has been chaired by Ed Silins and will shortly be chaired by Bill Koenig.

These eight committees do a lot of the startup work on the projects that eventually lead to standards. The committees are charged with continual review of their field for possible implications for standards. They are charged with making the first draft of standards. They are charged with going to the board and recommending that a particular topic be made into a standard. Once a draft is reviewed by the parent board and exposed to the profession, the operating committee has not finished its work. It is then the responsibility of the operating committee to receive the responses from the profession and to use those responses upon which to base a new draft of the standard. In every case, the standard is thus drafted at least twice. The operating committee will resubmit the revised draft to the ASB, which will then decide whether to promulgate the standard, completely drop the whole thing, or reexpose a draft. This process can get very time consuming.

My favorite project in this regard is the standard on economic assumptions for pension plans, which is coming to an end. We have a draft out now that is being reexposed for the third time. That project started in 1990, and we may see a final standard being promulgated in 1997. This project has been fraught with delay and problems, but I think we still may see it to its conclusion.

I first became involved in the standards process during the development of *Standard No. 22* on asset adequacy analysis. I was a member of a subcommittee. The Life Committee, as with many of the operating committees, follows the practice of appointing a subcommittee to do the first draft of a standard. The draft then goes to the operating committee followed by the parent board. As a previous member of a lower-level committee, I was excited about the chance to draft standards for asset adequacy analysis. Of course, by the time the draft had gone through the operating committee and then the ASB itself, I did not recognize some of the things that I had written.

It is worth pointing out that the ASB and its operating committees place a great deal of reliance on the responses of the profession. I have mentioned the exposure process. Every standard is exposed for a 90-day period during which the profession is given a chance to respond. The responses are viewed as rational, reasonable responses to a situation. If somebody writes in and says, you clearly misworded this paragraph or you clearly misunderstood this concept, the operating committee will usually be responsive and make the change. The board gives a careful review to

good responses for change. If the responses result in major changes, the standard will be reexposed.

After my experience with *Standard No. 22* and working my way up through the Life Committee and to the parent board, the other standard that is most clearly etched in my memory is *Standard No. 24* on sales illustrations. I want to talk about this a little bit, because it is very essential to understanding where we are and where we are headed, and also because it is the most recent important project on the part of the Life Committee.

The whole process started in the NAIC, as it had to. If radical changes in the way we illustrate policies were going to be made, they had to start at the NAIC. The NAIC was only too well aware of the fact that sales illustrations were the subject of innumerable abuses and they wanted to correct those abuses. Furthermore, the NAIC was being pushed by Senator Howard Metzenbaum who wanted to accuse the regulatory structure of not doing its job and then to bring regulation up to the federal level. The NAIC, being under fire and wanting to do something quickly, led to a quicker and deeper involvement on the part of the ASB and its Life Committee than might otherwise have occurred. By the winter of 1993–94 the process was well underway. At that time and well into the spring of 1994, the NAIC was mainly focusing on a sales illustration regulation that would have emphasized the illustration of guaranteed values or past performance. If that trend had continued, there would not have been much need for involvement on the part of the ASB.

By the summer of 1994, some different ideas began to take hold which I attribute to Bob Wilcox and Tom Foley. They were the chairperson and vice chairperson of the NAIC working group on illustrations. The idea of basing sales illustrations on recent experience was beginning to take hold in the regulatory community, with those of us on the ASB, and with those in the industry following the process. It was a definite switch in the philosophy of the working group to base illustrations on recent experience.

This philosophy was something that called for a challenge to the ASB. There was the concept of a self-support test and a lapse support test that the NAIC had developed. The NAIC, however, had not developed the details of the exact operation of these tests.

In September 1994 the Life Committee became involved. One of the first things it did was to listen to the NAIC request for recommendations on the design of these tests. The Life Committee made recommendations to the NAIC which, with minor modifications, went into the model regulation.

The Life Committee was also a source of several other innovations that found their way into the regulations. These innovations included the idea of a policy form aggregate test, rather than an individual age and plan test; the idea that it was not necessary to ban persistency bonuses, but design a strong lapse support test that would eliminate the most egregious of the persistency bonus abuses; and the idea of the Generally Recognized Expense Table (GRET). These ideas did not necessarily find their way into the model regulation in exactly the original form, but the ideas came from the Life Committee. For the reasons I have already mentioned, it was necessary that the regulation contain these concepts. The standard could not step out front with these concepts.

At the same time, it was necessary that the people who were writing the standard work very closely with the people who were writing the regulations, because not only does the standard depend on the regulation for its validity, but the regulation also depends on the standard. In several places the regulation mentions the standard and, in a sense, gives authority to the standard to set out the details of some of the processes that are in the regulation in broad form only. It was a parallel process. Certainly, the regulators are not going to give this kind of authority to the ASB without knowing the text of the standard. The process was unprecedented, and I don't think it will happen quite the same way again. The ASB, NAIC, and industry advisors working together to develop something in parallel that was unique. The time schedule was also unique. The Life Committee first became involved in September 1994. By the spring of 1995, the standard was exposed. During the summer, the Life Committee rewrote the draft as a result of the exposure and as a result of further dealings with the NAIC. In the fall of 1995, *Standard No. 24* was adopted by the ASB and promulgated for an effective date of early 1996.

The reason I do not think a standard will be adopted so quickly again is that the ASB and particularly the Life Committee under Ed Silins were taking on a public policy responsibility. There are other Academy committees that are better suited to that job.

You are going to hear about upcoming developments in the field of nonforfeiture. That is a field where we have a similar process in that the NAIC is very interested in doing something where there is going to have to be an accompanying standard. There is an Academy working group that is doing much of the innovative work that the Life Committee did in the case of illustrations. I think in the future we will have the whole Academy structure involved in these developments, rather than the ASB taking the lead. Nonetheless, right now, we have to be very careful about developments in nonforfeiture. We have to monitor them and make sure that the ASB is ready to respond.

Let me close by telling you where things are in the ASB in general and where we are headed in various fields. In the life field, the structure of standards is more in place than in other areas of practice. Much of the current effort of the ASB is directed at some major restructuring in some of the other areas of practice. The casualty practice area is writing a whole set of standards to deal with the general subject of ratemaking. The pension area is writing a whole set of standards having to do with the selection of assumptions for the valuation of pension plans. The health area is writing several standards on ratemaking and rate filing. Those areas need the structure that I think the life practice area already has. In the life area we are looking at some of the perhaps less important gaps that need to be filled and we're working on those. I do not want to imply there is a sense of quiescence here, but things are not quite at the level in life practice as they are in some other practice areas. Things, of course, could change if the nonforfeiture effort goes ahead rapidly. I cannot think of anything more radical than what is currently being considered for nonforfeiture, and the accompanying standard will also be radical.

Finally, I want to say that serving on the ASB is important and challenging. I think that this kind of work contributes something to the actuarial profession by strengthening our concepts of professionalism. Written standards are an extremely important attribute of professionalism.

Mr. Thomas C. Foley: I am going to talk about actuarial standards and the ASB from a regulator's viewpoint. In order to give you some background about where I come from with regard to regulations, I thought I would give you my views of regulation and regulatory attitudes. Because I was a company actuary for 20 years before I became a regulator, I have a perspective that a lot of regulatory actuaries do not have.

There are those in the industry who view regulation as a necessary evil. We are going to look at *Standard No. 8* which contains a required statement which supports the view that regulation is a necessary evil. On the other hand, there are company actuaries who have a neutral view about regulation: it is neither good nor bad, it is just something that has to be done. Then there are those few professional actuaries working for companies who think that a by-product of their professional activity is providing information to regulators.

Some regulators have, what I call, a checklist mentality. That is, they feel as if there are these ten things that they are supposed to check on. Whether these things, as put together by a given company, make any sense is irrelevant as long as those ten things are listed and can be checked off.

There are regulatory actuaries who think that the companies and company actuaries are focused almost exclusively on making profit, and the regulatory actuary is charged with protecting the broad base of policyholders. Most of us do not have that narrow focus, but protecting policyholders is where we come from.

Finally, there are regulatory attitudes where, first of all, we look at competency displayed by a company, by the action, and in an actuarial memorandum. Do the actuary and the company appear to know what they are doing? If not, then it is my sense that downstream, policyholders are going to be hurt. Second, does this company, this actuary, and information exhibit a degree of fairness across all publics with which the company deals? This is the issue where we are certainly charged with not only protecting policyowners, but also understanding that a policyholder is not going to be protected unless we look at solvency, too. The company needs to be ongoing so promises can be met. Clearly, the employee's competency and fairness leads to long range success for both policyowners and business owners.

If you look across the industry at the companies that exhibit a degree of competency and exhibit a degree of fairness to all their publics, those are the companies that consistently, year after year, decade after decade, thrive and do very well. The companies that "rob Peter to pay Paul," that may provide a very attractive-looking policy when it is purchased but which turns into something different two years down the road, are the companies that we read about all too often in *The National Underwriter* as being in trouble.

If competency and fairness can be mandated in a standard, then maybe that is the way to go.

To give you an example of one standard, I want to look at *Standard No. 8*, Regulatory Filings for Rates and Financial Projections for Health Plans. *Standard No. 8* is the standard that provides at least some bare bones idea about what needs to be in an actuarial memorandum, and what an actuary needs to go through in order to prepare an actuarial memorandum—for example, price the product, do the monitoring, and interact with the regulatory body.

Actuarial Standard of Practice No. 8
Regulatory Filings for Rates and Financial Projections for Health Plans Adopted 1989

5.1 Purpose of Filing
... prepared for the purpose of demonstrating compliance with regulatory authority and may not be appropriate for other purposes.

5.2 Recognition of Benefit Plan Provisions
... recognize all pertinent plan provisions when preparing or reviewing a health filing.

5.3 Consistency of Business Plan and Assumptions
... business plan may include but is not limited to:

- expected sales results
- expected characteristics of the insured population based on underwriting practices, etc.
- expected commissions and expenses
- expected overall financial results
- planned method of sale and renewal
- expected timing and magnitude of future rate increases
- health-care delivery system contracts

5.4 Reasonableness of Assumptions

5.5 Use of Past Experience to Project Future Results

The purpose of the filing should include a statement of purpose including wording such as "demonstrating compliance with regulatory authority and may not be appropriate for other purposes." The actuary is saying that the actuarial memorandum is not appropriate for any other purpose other than to convince the regulator that the company is doing the right thing.

In recognition of benefit plan provisions, the standard goes on to say that the actuary needs to be familiar with the business plan of the company when he or she is developing and monitoring a product. The business plan needs to include at least these things: expected sales results, expected commissions and expenses, expected overall financial results, and so forth.

When I was with the Florida department, we took *Standard No. 8* and developed a list of items that should be involved in a health actuarial memorandum. The basis for this list was *Standard No. 8*. It's my contention that these are at least the steps to consider if one is going to develop a health policy, price it, and prepare to monitor it. *Standard No. 8* does not say that when the actuary interacts with a regulator he or she needs to provide all these items. But, it seems to me, as a result of what the standard does say, the actuary is going to have to provide all these items. Now I would ask should a standard be more explicit than *Standard No. 8*? Should it get to this level, where it says if you are going to interact with a health policy, you need to provide the items listed below.

REQUIREMENTS FOR A HEALTH RATE FILING ACTUARIAL MEMORANDUM

1. Scope and Purpose
2. Benefit Description
3. Renewability Clause
4. Applicability
5. Morbidity
6. Mortality
7. Persistency
8. Expenses
9. Marketing Method
10. Underwriting
11. Premium Classes
12. Issue Age Range
13. Area Factors
14. Average Annual Premium
15. Premium Modalization Rules
16. Claim Liability and Reserves
17. Active Life Reserves
18. Trend Assumption—Medical and Insurance
19. Minimum Loss Ratio
20. Anticipated Loss Ratio
21. Distribution of Business
22. Contingency and Risk Margins
23. Experience—Past and Future
24. Lifetime Loss Ratio
25. History of Rate Adjustments
26. Number of Policyholders
27. Proposed Effective Date
28. Actuarial Certification

We adopted this list in Florida. When I moved to North Dakota, I was surprised to find that well over half of the actuarial memoranda that I get in North Dakota use this same format. I do not know whether actuaries have finally picked up on the concept that these are the steps that they need to go through when they price a health policy. If indeed they are going to interact with the regulatory actuary in a professional manner, then what they need to do is explain to the regulatory actuary that these are the steps that they went through.

I will now talk a little bit about where we are going with life nonforfeiture. Historically, we have had formula minimum nonforfeiture values. Since at least 1981, the formula minimum nonforfeiture values have been well outside the realm of real activity for policyholders' purposes. If the formula minimum cash value for a given age and plan and duration is $200 per $1,000 of face amount, most of the action is taking place at $300—$400 per $1,000, either because of dividends or nonguaranteed elements. Regulators and commissioners are starting to understand that we have a minimum nonforfeiture law, but the action is taking place well outside of any minimums that are defined in that nonforfeiture law and, therefore, there is no real regulation going on. What we are trying to do is replace the formula minimum with a different way of going about things. The motivation for this change, explicitly, was the fact that fund-based policies started in this country about 15 or 16 years ago in the form of universal life. The Life and Health Actuarial Task Force spent about 12 years trying to reconcile the formula minimum cash values which work OK for traditional policies with those of fund- based policies, and it kept getting accused of rate regulation.

We took a significant step away from that attitude a couple of years ago. We went back to basic principles. What we are thinking about now is to ask the company to

strike a deal with policyholders and to develop a plan consisting of, potentially, three elements. One will be a nonforfeiture plan. Basically this plan will lay out how to calculate nonforfeiture values for the policy. There also will be a plan for nonguaranteed elements. Finally, there will be a plan for dividends. Potentially, a policy could have all three plans; more likely it will have two of those three plans. It will be different because the regulation is not going to be prescriptive about what you, the actuary, can do. You can provide guarantees if you want to. You don't have to provide guarantees. But you must clearly indicate to the policyholder what will be provided.

If we are going to talk about a nonguaranteed element plan and a dividend plan, then we need to have some sense of the standards that will evolve around these ideas. We get to the point of considering if any kind of activity will be allowed. Will I be able to say to a policyholder, "Here is the dividend plan. I plan to pay dividends. I may or may not, depending on how I feel about it when we get to that point in time." Will this be acceptable behavior? Probably not. On the other hand, will the standard require that these three plans state that at, for example, year eight, such and such will happen based on the earnings rate minus 200 basis points and be tremendously prescriptive? The standard will allow companies to have such practices. Will the standard force companies to do that? I doubt it.

To give you some sense of where we are and what we have to build with in developing these standards and developing this model, I thought we should take a look at what is in *Standard No. 15*. What I wanted to concentrate on in *Standard No. 15* is the contribution principle. The contribution principle requires that aggregate divisible surplus, which is determined by the board, be distributed among policies in the same proportion as the policies are considered to have contributed to divisible surplus. That seems to bring a degree of fairness to this process that when we look at *Standard No. 1*, may well not be there for nonguaranteed elements.

Standard No. 15 seems to say that we have this chunk of money and we are going to pay it back in the form of dividends, the way it was contributed to us. This principle does not allow us to turn around then and say to policy year one people, "we are going to pay you an exorbitant amount of money," and to policy year ten people, who presumably, we don't care about anymore, "We are not going to pay you much of anything."

Actuarial Standard of Practice No. 15
Dividend Determination and Illustration for Participating Individual Life Insurance
Policies and Annuity Contracts
Adopted 1980, Revised 1985

2.1 Contribution Principle
The contribution principle requires that aggregate divisible surplus be distributed among policies in the same proportion as the policies are considered to have contributed to divisible surplus.

4.2 Methods of Applying Contribution Principle
The contribution method, also known as the source of earnings method, is the method most commonly used to apply the contribution principle. Other methods ... include:
a. the asset share method;
b. the fund method;
c. the experience premium method;
d. the percentage of premium method; and
e. the reversionary bonus method.
It is the application of a particular method, by means of the experience factors, which determines whether or not it follows the contribution principle—not the method itself.

5.1 Contribution Principle is Generally Accepted Practice
The use of the contribution principle in determining dividends is generally accepted practice in the United States.

In stark contrast, *Standard No. 1*, has three paragraphs regarding nonguaranteed elements and how nonguaranteed elements can be developed. "One possible policy is to seek at each redetermination to adjust the original nonguaranteed charge [etc]. Under this policy, anticipated experience plays the key role and explicit profit margins would usually not be changed after issue." That is a way to do it. One sets profit margins and, basically, that seems to exhibit some degree of fairness to all people.

Actuarial Standard of Practice No. 1
The Redetermination (or Determination) of Non-Guaranteed Charges and/or
Benefits for Life Insurance and Annuity Contracts
Adopted 1986

4.3 Examples of Client (Redetermination) Policies
One possible policy is to seek at each redetermination to adjust the original non-Guaranteed charges or benefits for differences between the experience anticipated at the time of redetermination and that underlying the original non-Guaranteed charges or benefits. Under this policy, anticipated experience plays the key role and explicit profit margins would usually not be changed after issue.

A second possible policy is similar to the first except that adjustments are made only when the redetermined charges or benefits would be less favorable to the insured.
A third possible policy is for the company to set non-Guaranteed charges and benefits (at issue or at redetermination) to obtain a particular competitive position in the marketplace.

Of course, many other policies are possible.

The second paragraph states, "A second possible policy is similar to the first except that adjustments are made only when the redetermined charges or benefits would be less favorable to the insured." I have read that wording a dozen times and every time I read it, it comes out, "Well, if I can take something away from the policyholder, I will." Tell me a different way to read that.

The third paragraph states, "A third possible policy is for the company to set nonguaranteed charges and benefits …to obtain a particular competitive position in the marketplace." This is one of my favorites, as you might well imagine. I think about Mary Smith, my hypothetical policyholder in downtown Bismarck. I think about her being subject to a company somewhere that is deciding, based on their desired competitive position, how much value she is going to get. The real kicker is, "of course, many other policies are possible."

With regard to a nonguaranteed element, it seems like *Standard No. 1* allows for a way of providing value to the policyholder by basically saying that anything goes.

Yet, on the dividend side, there seems to be a structure that is missing with nonguaranteed elements. I point out these differences primarily so that you understand the process as we try to develop the new nonforfeiture law for life. It is my sense that we are going to have to have a significant meeting of the minds between nonguaranteed elements and dividends. At this point in time, it would appear that whatever evolves in nonforfeiture is going to be closer to what we now have for dividends, rather than for what we now have for nonguaranteed elements.

Standards would be helpful for regulatory actuaries if, as I said earlier, they could enhance the need, the desire, and the recognition that competency is important. Then, once the competency is in place, the actuary is going to have to go to management and insist on a level of fairness. Based on my experience, competency leads to successful companies. If we have successful companies then we have happy policyholders, and the system works well.

Mr. Koenig: I'd like to tell you a little bit about my personal experiences on the Life Committee so far, what I know of our plans for the coming year, and a little bit about what the future may hold. I was not really all that aware that there was a Life Committee, although if I thought about it, I certainly would have wondered how the esteemed members of the ASB managed to accomplish as much as they did without any help.

I was recruited to the Life Committee when someone in our office passed my name as a willing volunteer to someone in the ASB hierarchy. Time passed, and one day I got a call from Ed Silins, current chairperson, asking if I was still willing. I was then

on the Life Committee. There are presently 12 members on the committee, including myself. That would seem adequate for a normal workload, but we certainly do seek the help of experts who would be helpful for any particular project. Interested parties who had followed the life illustration work from day one, and who attended the meetings, were very helpful with their participation. Again, we do need new members every year.

Whether by design or accident, the Life Committee has a healthy mix of members by experience, age, type of experience, and company background. Ed has run a tight ship. He has set a good example for chairpeople to follow. It is the Life Committee's role to draft possible ASP for ASB consideration, as Frank outlined. It is the role of the Life Committee to advise the ASB on whether a standard is desirable in a given situation. Ed has not let us lose sight of that role and drift too long in the interesting and enjoyable realm of discussing other woes of the world or ways it could be made better, by means other than ASP. As a result of Ed's leadership, the Life Committee meetings have always been productive.

I have been told by wise veterans of the ASB that the role of the ASB has changed over time. It was once thought that the ASB could advance the state of actuarial practice dramatically by codifying only what were deemed the very best practices, thus eliminating practices that might even be very common, but were out of favor with the then ASB members. This approach has changed somewhat. Rather than serve as a quasi nonelected legislative body for actuarial practice, the ASB takes the view that it attempts to codify existing good practice in sufficient detail to be of use to practicing actuaries, eliminating, hopefully, the indefensible worst practices.

This difference can become a bone of contention with regulators. Some regulators would very much like the ASB to regulate for them. One thing I very much fear over the next few years is that the nonforfeiture proposal will have gaping holes that the regulators expect can be filled by the ASB, but cannot be filled.

My first experience on the Life Committee was working on *Standard No. 24*, the companion to the illustration model regulation. The Life Committee, and the ASB itself, played an important role somewhere between the simple codification of practices dictated by the regulation, and the arguably impossible determination of which legal practices, and some not uncommon practices, should be deemed to be outside the scope of accepted practice. The Life Committee came into some criticism as a result, and I think the criticism was unfair.

Two examples of the criticism come to mind: the specifics of the economic viability tests and utilization of loss leaders. With respect to the economic viability tests there is nothing in actuarial practice that requires single life products to break even

in 15 years or 20 years for joint life. There is no magic in the 100% persistency assumption after 5 years for determining what is lapse supported and what is not.

Similarly, from an individual company's view, there may be no obvious evil in utilizing the respected marketing technique of loss leaders, or in the rewarding of long-term persisters with extravagant bonuses for their loyalty, but used as a marketing tool for all.

Where was the middle ground? The Life and Health Actuarial Task Force felt strongly that persistency bonuses should be outlawed entirely. The Life Committee, especially Dick Miller of Tillinghast, helped the working group test a number of illustrations to see which would likely fall outside the bounds of the test they were considering. The 15-year test worked OK for most products. I think one particular current member of the Life Committee can take credit for the 20-year test for joint life products where mortality margins do not and cannot contribute much to expense recovery. I think the Life Committee can take credit for convincing the working group that persistency bonuses which fell within the bounds of the lapse support test were not inherently abusive.

Then there is the GRET. The development of the GRET was a direct result of ASB involvement. This approach defused a most contentious issue of concern to companies other than those who use full allocation of overhead expenses to their products.

In both examples, the ASB consulted with the working group to propose reasonable rules. Perhaps another group should more properly have stepped in, but the ASB was there and the time frame was short. In neither example was it left to the ASB to promulgate, on its own authority, a definition of lapse support or self-support, or to define a safe harbor for alternative methods of expense allocation.

Now for the current agenda of the Life Committee. The first things we are going to deal with are some holdovers from the past.

We have to look at *Standard No. 15*, because of the promulgation of *Standard No. 24*. A draft of changes has been produced and will be discussed. If acceptable, the draft will be sent to the ASB for review. The gist of the revision is simple: the section in *Standard No. 15* dealing with illustrations is applicable in a state until the illustration regulation is adopted, at which point *Standard No. 15* is superseded by *Standard No. 24*.

Then there is a question of whether we have to revise *Standard No. 1* on nonguaranteed elements. At this point, there does not seem to be any need to

revise *Standard No. 1*, in light of the new illustration regulation, because *Standard No. 1* does not address illustrations at all. Whether *Standard No. 1* will have to be amended because of nonforfeiture work remains to be seen.

Another subject that is gaining a fair amount of interest is devising a standard for the management of closed blocks of business. With demutualizations and mergers and acquisitions, there is quite a bit of interest in closed blocks. Also, there is an Illinois regulation that refers to actuarial standards applicable to closed blocks of business on demutualizations. Our approach has been to draft, consider, critique, and redraft as necessary. Next week, I hope to have the committee outline the elements of the standard and identify the most interested parties to work with me on the drafting, including some experts not on the committee. At this point, the ASB has not formally decided that such a standard is necessary, but they have decided that they would like to see a draft and to see what a potential standard might look like.

The next item has to do with reinsurance. One of the ways topics get advanced for ASB consideration is through regulatory suggestion. This potential project arises from that source. A regulator has suggested that *Standard No. 11* is deficient. The Life Committee, as a group, will take another look at the issue and either act or move it off the agenda.

Another item that arises from regulatory suggestion has to do with derivative instruments and cash-flow testing. It has been suggested that *Standard No. 7,* regarding cash-flow testing, would be strengthened by a direct reference to the need to model derivative investments. The Life Committee will discuss this proposition in response to the ASB, with either a proposed revision or reasons why none are necessary.

Now I come to nonforfeiture. There is a joint effort with the Academy and the Life and Health Actuarial Task Force to do a dramatic overhaul. I am inclined to think that it is a little too early to begin drafting a standard of practice given the state of the proposed new law. It is not too soon, however, to start thinking about how the Life Committee can help or what a standard might look like.

As I mentioned previously, I fear that the Life and Health Actuarial Task Force working group will be tempted to assign a larger role to the Life Committee than it has the power to play. The working group is breaking new ground, and when it comes to something like requiring a "fair" nonforfeiture benefit, I do not think that the ASB can define "fair" without firmer regulatory guidance. There is a wide divergence of what people think is "fair" just among the advisors to the working group. The Academy is advising the working group and filling the role that the ASB did with the illustration regulation.

I was interested in Tom's discussion of the differences between *Standard No. 1* and *Standard No. 15.* He described a plan in three parts: calculation of nonforfeiture benefits, nonguaranteed benefits, and dividends. He referred to a potential plan for dividends that says something like, "We may pay dividends, we may not, depending on how we feel."

It happens that my company, like many mutual companies, has a good reputation for and history of paying dividends. The contribution principle is widely followed, to every extent humanly possible. At the same time, the contribution principle says nothing about how much is to be distributed in dividends. The plan is that every year the board of directors will meet and, with the advice of management and the actuary, determine an amount of dividends to be distributed fairly via the contribution principle. There is a real divergence of opinion, I think, as to whether the universal life rules, as administered by some states (notably New York), provide and impose more or less discipline than the contribution principle. I think that sort of issue is found in some of the new nonforfeiture law discussion. We are dealing not just with the part to which Tom referred as above $200, but also to the first $200.

Annuity and variable life illustrations will be on the docket of the Life Committee fairly soon. I anticipated that the Life Committee efforts would follow naturally from the combination of new *Standard No. 24* and regulatory efforts on annuities and variable life. Neither of these efforts seem to be progressing quite at the speed that we might have earlier thought. At the same time, I found out at this meeting that New York is getting ready to promulgate some rules on the illustration of annuities and variable life. New York may spur us to quicker action than we otherwise might have thought.

Mr. Jeffery D. Miller: In my experience, I find it to be a bit rare that regulatory actuaries have the breadth and depth of experience that you have. I have worked with maybe four or five regulatory actuaries who have your level of experience and understanding of the business and, therefore, who can really use the competency standard in the regulatory process in an effective way. I would ask you what has motivated you to choose this path in your career, and what is your view of the future of regulatory actuaries in terms of having the experience necessary to regulate in the manner to which you refer.

Mr. Foley: That is an interesting question. I spent three years, beginning in 1970, at Northwestern Mutual where the attitude was to expect competency and fairness from all employees. Then I left because I did not want to be an expert in a narrow area; I felt I wanted to have more breadth. I ended up working for several small companies as chief actuary, but I kept moving and I could not figure out why. In

1991, I became a regulatory actuary in Florida. Within a few months, it became very clear to me the problem I had had for the previous 15 years. I was going about things in terms where we are supposed to have a competency and fairness for all our public, but I found that some companies have a focus primarily on the bottom line. Some of the attitudes did not mesh well. What has evolved for me in the last five years as a regulatory actuary is that I would much rather try to judge a company by competency and fairness than the laws and rules to which I am bound. If competency and fairness exist, then I know the policyholders are going to be well served. If enough actuaries in our profession understand that those two things really are the key to their survival, to their doing well, and to policyholders doing well, it may not be necessary that all regulatory actuaries get to the same level of breadth and experience. State budget constraints cause some difficulty, but I am hopeful that we can find ways to provide more breadth from the regulatory viewpoint. The sales illustration model seems very prescriptive relative to what it could have been, relative to where it started two years ago, it gives actuaries some flexibility. If we can get this kind of regulatory breadth in the future, there are glimmers of hope.

Mr. Miller: I would like to hear Jack Turnquist's reaction to the comparison of and differences between *Standard No. 1* and *Standard No. 15.* [Mr. Turnquist, President of the AAA, was also in the audience.]
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Mr. Jack M. Turnquist: *Standard No. 1*, basically, was inherited. It was probably the most controversial exposure that went before the interim ASB. There was diversity of opinion where insurance company management basically felt they were being told what to do by the creation of an ASP. That is bad business, because if one creates an actuarial standard that requires, for example, following certain practices of equity or whatever in the redetermination of rates, the standard is usurping the authority of the company. What could happen is companies would reestablish rates or nonguaranteed benefits without the benefit of the actuary. The illustration standard started much like this. The ASB held a public hearing several years ago to address the fact that we had a problem with nonguaranteed benefits and with illustrations. Some of the views expressed indicated the ASB should just go ahead and create a standard of how to do illustrations. But, if we did that, the result is the actuary is locked out of the process. If the actuary is not involved in the illustration, the company can do whatever it chooses. At any rate, there was tremendous diversity of opinion in that we could not try to dictate company policy by telling the actuary how to make these determinations. There are some actuaries, by the way, who believe that the contribution principle should apply to all nonguaranteed elements and there are some at just the absolute opposite end.